
Insurance Counsel

No Attorney-Client Relationship Exists between Reinsurer and Attorneys Hired by Ceding Insurer to Defend Policyholder

Dismissal of Reinsurer's Malpractice Suit Upheld

Zenith Insurance Co., v. O'Connor, 148 Cal.App.4th 998, 55 Cal.Rptr.3d 911 (2d Dist., Div. 3, 2007)

Case at a Glance

The absence of an attorney-client relationship between a reinsurer and a law firm hired by the reinsurer's ceding insurer to defend the underlying policyholder precluded the reinsurer from alleging a cause of action for attorney malpractice against the law firm. The reinsurer was not a third party beneficiary of the ceding insurer's contract with the law firm. Nor did an implied contract exist between the reinsurer and the law firm. The fact that the reinsurer had reinsured 100 percent of the ceding insurer's liability to the policyholder, the reinsurance contract obligated the reinsurer to reimburse the ceding insurer for all legal fees incurred in defending the policyholder, and the law firm fulfilled the ceding insurer's statutory and contractual obligation to report to the reinsurer on the progress of the litigation did not provide a sufficient basis for finding an implied attorney-client relationship or an intent on the part of the ceding insurer and the law firm to benefit the reinsurer.

Summary of Decision

Royal Insurance Company's policyholder sought coverage for environmental cleanup liability under a policy Royal had reinsured with Zenith Insurance Company. Under the terms of the reinsurance agreement, Zenith was obligated to reimburse Royal for 100 percent of Royal's losses under the policy, including costs incurred in defending the policyholder. The reinsurance agreement expressly recognized Royal's right, in its sole discretion, to settle claims

against the policyholder without interference from Zenith. Zenith, however, had a statutory right to receive any information Royal possessed regarding the reinsured liability of the policyholder, including progress reports on the progress of the litigation against the policyholder.

Royal delegated at least part of this duty to keep the reinsurer informed to Cozen O'Connor, the law firm Royal had hired to defend the policyholder in the underlying environmental cleanup litigation. During the course of the environmental litigation, Zenith asked Cozen about Royal's failure to seek contribution from other insurers on the risk. Cozen advised Zenith that because of certain conflicts of interest, Cozen was not able to pursue any of the potential contribution claims. Zenith then demanded that Royal retain other counsel to pursue those claims and Royal did so.

After settling the environmental claim, Royal demanded reimbursement from Zenith pursuant to their reinsurance agreement. Zenith paid only a fraction of Royal's demand, and then sued Royal for breach of contract and declaratory relief. In essence, Zenith's complaint alleged that Royal had mishandled the adjustment of the environmental claims and, specifically, had failed to timely pursue contribution and indemnification claims against other insurers.

Zenith later amended its complaint to allege a cause of action against Cozen for professional malpractice. Cozen demurred to the malpractice cause of action on the ground that it had no attorney-client relationship with Zenith, and thus owed Zenith no duty of care. Zenith maintained that a duty of care arose, despite the absence of an *express* agreement between itself and Cozen, under either of two theories: (1) an *implied* contract for legal services existed between itself and Cozen, or (2) it was an intended third party beneficiary of the express contract between Royal and Cozen. Finding that Zenith had failed to allege facts sufficient to support either theory, the trial court sustained Cozen's demurrer.

In affirming, the California Court of Appeal, Second District, adopted reasoning that in most circumstances will preclude reinsurers from suing attorneys hired by ceding insurers for malpractice. Critical to the court's analysis was the nature of the relationship between Royal and Zenith under the reinsurance agreement. Although Zenith reinsured

the full amount of the claim, including the costs of defense, only Royal was contractually obligated to the insured and only Royal had the power to investigate, defend and settle claims against the insured. Zenith's only obligation was to reimburse Royal. Given the respective rights and duties of Zenith and Royal, the court determined that a conflict of interest existed between the two insurers with respect to the defense of the policyholder in the environmental litigation. The reason: Decisions regarding the defense and settlement of the environmental litigation against the policyholder exposed Royal, but not Zenith, to extracontractual liability for bad faith. This conflict of interest precluded Cozen from ethically representing both Royal and Zenith, and, in the court's view, made it "impossible to conclude that either Royal or Cozen ever intended to confer upon Zenith beneficiary status of Cozen's legal services performed for Royal"—at least in the absence unambiguous evidence of Royal's avowed intent to benefit Zenith despite knowing of the consequences of a conflicted defense.

The court made short work of Zenith's attempt to pin third party beneficiary status on Cozen's knowledge that Zenith had reinsured 100 percent of Royal's risk, including Royal's obligation to pay legal fees. The court pointed out that Zenith did not "pay" Cozen, but simply reimbursed Royal. Moreover, the court noted, even if Zenith did pay Cozen's fees directly, the mere payment of attorneys' fees does not establish the existence of an attorney-client relationship or third party beneficiary status.

Similarly, the court found nothing in Cozen's communications with Zenith that justified treating Zenith as a third party beneficiary of the attorney-client contract between Cozen and Royal. Cozen, the court observed, was doing no more than discharging Royal's statutory duty under Insurance Code § 622 to communicate to Zenith all the knowledge and information that Royal possessed with respect to any of Royal's reinsured liability.

Turning to Zenith's implied contract theory, the court stressed that an implied contract, no less than an express contract, requires an ascertained agreement. The only difference between the two is in the mode of proving the terms of the agreement. Both depend on proof of the parties' mutual intent, which in the case of an implied contract must be inferred from the conduct, situation, and relationship of the

parties. The court determined that Zenith failed to allege facts from which the mutual intent of Zenith and Cozen could be inferred. Zenith, the court reasoned, alleged only its unilateral belief that an attorney-client relationship existed based on its ultimate responsibility for Cozen's fees and the contacts and communications it was allowed to have with Cozen. As the court had already explained, these allegations were insufficient to support a finding that Cozen intended to benefit Zenith, let alone a finding that Cozen intended to enter into a contractual relationship with Zenith. To the contrary, Cozen's refusal to pursue contribution actions and Zenith's demand that Royal hire *other* counsel to undertake the task suggested, if anything, that Cozen did not represent Zenith. // DiMugno

Comment

Three points should be made about the *Zenith* case. (1) If the conduct of the law firm harmed Royal, Zenith should be subrogated to its rights to recovery. Various states are uncomfortable about permitting subrogation in this context, but it is hard to see why. (2) Indeed, it is hard to see why Royal should not be permitted to assign its claim against the law firm to Zenith, although California has erroneously led the way in saying exactly this. See Michael Sean Quinn, "On the Assignability of Legal Malpractice Claims, 37 S.TEX. L. REV. 1204 (1996). Interestingly, some courts have recently adopted the rule that legal mal claims are assignable. *New Hampshire Insurance Company v. McCann*, 707 N.E.2d 332 (Mass. 1999). (3) It is not clear from the text of this opinion why the law firm did not represent Zenith. It communicated directly with Zenith regarding a case it was handling, in which—as the law firm knew—Zenith has financial exposure. The law firm certainly communicated with Zenith in writing; it would be surprising if there were not telephone calls and/or emails. The court rejects these communications as the provision of legal services, since the firm was performing work for Royal required by a state statute. But this argument, as it stand, is logically invalid. Whether the letters, and other communications, constituted legal services would depend on their content. If the communications contained legal advice, for example, then they would constitute the provision of legal service, and an attorney-client relationship would be established,

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irrespective of what the law firm consciously thought it was doing and irrespective of how Zenith at the time consciously conceived of the relationship. If there was the rendering of legal services, then there was an attorney-client relationship. See Section 14 of the RESTATEMENT OF THE LAW GOVERNING LAWYERS 125 (2000). Clearly, this issue cannot be determined without detailed examination of the communication documents and testimony about verbal communications. // Quinn

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